No. 86-490

In the Supreme Court of the United States

OCTOBER TERM, 1986

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ILLINOIS CEREAL MILLS, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

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TABLE OF AUTHORITIES

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1. Respondent seems to agree that the Fourth and Seventh Circuits have issued conflicting interpretations of the investment tax credit statute as applied to a factory electrical system. The primary thrust of respondent's submission (see Br. in Opp. 4-6) is to trivialize the differences between those conflicting interpretations in an effort to suggest that the conflict lacks sufficient practical importance to justify this Court's attention. Respondent's suggestion is quite wrong because there is a fundamental difference in legal principle between the rule established by the Fourth Circuit in *A.C. Monk & Co.* v. *United States*, 686 F.2d 1058 (1982), and the rule adopted by the court below—a difference that goes to the heart of the administration of the investment tax credit.

The circuit conflict that must be resolved here is not, as respondent suggests (Br. in Opp. 4-6), over the details of *how* the cost of a factory's primary electrical system is to be allocated between machinery and building maintenance. The basic dispute concerns *whether* such an allocation should be made at all. Our position, which follows the

Fourth Circuit's approach, is that a primary electrical system is a "structural component" of a factory building and that no portion of the system can ever qualify for the credit unless the taxpayer proves such an "inextricabl[e] link[ ] to the present, specific machinery" that the system cannot "be reasonably adapted in the present building to more general uses" (686 F.2d at 1066). Respondent's position is that a primary electrical system automatically qualifies for the credit to the extent it powers machinery, something that a factory electrical system will invariably do. The practical difference between the two positions is enormous in terms of tax dollars likely to be lost if the Seventh Circuit's decision is followed.

Although respondent asserts (Br. in Opp. 6) that the practical difference is likely to be "small," the error of that assertion is evident if one contrasts the result here with the result reached by the district court on remand in *A.C. Monk*. The Seventh Circuit below held that 95% of respondent's electrical system qualified for the credit. Employing the Fourth Circuit's conflicting approach, the district court on remand in *A.C. Monk* held that no portion of the taxpayer's electrical system qualified. See 577 F. Supp. 4 (E.D. N.C. 1983).[1]

[1] In our petition (at 13-14), we also criticized the method of allocation chosen by the court of appeals—namely, a breakdown according to the percentage of electrical load used for various purposes. Respondent's effort (Br. in Opp. 5) to defend that method by reference to the percentage allocation of the credit between business and personal uses is misconceived. The investment tax credit is only available for business property, and Congress clearly intended that the credit would be allocated on a percentage basis for mixed-use property. But the fact that the credit is partially available for Section 38 property that is partially put to business use has no bearing on the question whether the percentage distribution of electrical power should be relevant in determining whether an electrical system is Section 38 property to begin with. The issue here is whether certain electrical components are "structural components" of a building, and, as the Fourth Circuit stated in *A.C. Monk*, "it seems difficult to conceive of a single bus duct, transformer, or piece of wiring being both a structural component and other property" (686 F.2d at 1065). On the other hand, it is by no means difficult to conceive of Section 38 property being both "business property" and "personal property" depending on the ratio of those respective uses.

A building's primary electrical system is, under any common-sense reading, a basic structural component of the building, and it is so recognized in the applicable regulations. Treas. Reg. § 1.48-1(a)(2). There is no ground for deviating from this understanding simply because the electrical system is used in part to power the factory's machinery. Otherwise, the fact that the electrical system of an office building is used in part to power typewriters, duplicating machines, electric pencil sharpeners, and other "tangible personal property" (I.R.C. § 48(a)) would entitle a taxpayer to claim an investment tax credit for part of the cost of that electrical system—a result that Congress plainly intended to prevent by making the credit unavailable for "structural components." Accordingly, the rationale of the decision below would undermine congressional intent by carving a substantial chunk out of the specific limitations that Congress imposed on the availability of the investment tax credit.[2]

2. As is discussed in greater detail in our petition (at 13-16), the Fourth Circuit recognized in *A.C. Monk* that Congress did not intend to create an absolutely inflexible rule respecting the definition of Section 38 property. The

[2] Respondent completely misses the point of the basic dispute here in asserting (Br. in Opp. 6) that "[u]nder Petitioner's approach, each of these [electrical system] components would have to be viewed separately to establish those components * * * which serve machinery and equipment and those other components which provide electricity for lighting and non-process heating and air conditioning." To the contrary, under our approach electrical system components are "structural components" of a building unless they are inextricably linked to the present, specific machinery, with the result that *none* of the components respondent describes would qualify as Section 38 property absent a showing of non-adaptability.

court explained that, if parts of an electrical system were so "inextricably linked to the present, specific machinery" that they could not "feasibly be adapted to [other] uses," they would not be deemed to be excludable "structural components" of the building within the meaning of the statute (686 F.2d at 1066). Respondent's suggestion (Br. in Opp. 6-8) that this approach of the Fourth Circuit does not conflict with the decision below is wholly without merit. The test posited by the Fourth Circuit establishes a narrow exception—"whether a manufacturer converting the building to an alternate process would be able, with reasonable alterations, to use the existing system, or whether he would have essentially to scrap the system and install another" (686 F.2d at 1066). It cannot seriously be maintained that this test can be reconciled with the decision below, which holds that respondent's entire electrical system qualifies for the credit except to the extent that it is used for lighting, heating, and building maintenance, even though the system's components "are not custom made specialty items, but rather are common 'off-the-shelf' goods" (Pet. App. 12a). It is true, as respondent says (Br. in Opp. 2), that we do not know what part of the instant electrical system might qualify for the credit under the Fourth Circuit's view of the law, since the Tax Court here, given its conflicting view of the law, made no findings about the system's adaptability to other uses. The fact that acceptance of our position might necessitate a new trial on remand, however, casts no doubt on our contention that the legal theories of the Fourth and Seventh Circuits are in square conflict.

3. The issue presented here is sufficiently important to warrant review by this Court. As noted above, the existing circuit conflict involves a fundamental principle concerning the application of the investment tax credit. As noted in our petition (at 12), this issue has sizable revenue consequences, with an estimated $275 million at stake in pending

cases involving factory electrical systems alone. Moreover, the IRS informs us that there are 12 pending cases, involving multiple tax years in the fast-food industry, in which a total of $85 million in investment tax credits are being claimed in reliance in part on the allocation rationale reflected in the decision below. Thus, even in light of the repeal of the investment tax credit in the 1986 Tax Reform Act, we believe that the conflict should be resolved by this Court. Compare *United States* v. *Chicago, B. & Q. R.R.*, 412 U.S. 401, 404 & n.6 (1973).

In addition, we note that the 1986 legislation does not necessarily eliminate the importance of this issue for future years. Congress on prior occasions has temporarily suspended or repealed the investment tax credit, only to reenact it later when economic conditions changed. See Pub. L. No. 89-800, § 1, 80 Stat. 1508 (suspended); Pub. L. No. 91-172, § 703(a), 83 Stat. 660 (repealed); Pub. L. No. 92-178, § 101, 85 Stat. 498 (restored). Congress's treatment of the credit in the 1986 Act is fully consistent with this past practice, since that law does not remove any of the investment credit provisions from the Code; it simply adds a new provision stating that "the regular percentage shall not apply to any property placed in service after December 31, 1985." Pub. L. No. 99-514, § 211(a) (Oct. 22, 1986). That provision is itself subject to numerous exceptions and transitional rules. Thus, the statutory structure at issue remains on the books despite the "repeal" of the investment tax credit, and the conflict between the Fourth and Seventh Circuits, besides affecting substantial sums in litigation for pre-1986 tax years, may cause uncertainty indefinitely into the future. Indeed, Senator Long, one of the architects of the 1986 legislation, has already predicted that restoration of the investment tax credit will occur with the next recession. See Daily Tax Rep. (BNA) at G-6 (Sept. 12, 1986).

4. Respondent asserts that this case is "not an appropriate vehicle" for resolving the circuit conflict because the

Commissioner in the instant case "did not argue in the Tax Court that adaptability was a factor to be used in determining" whether a factory electrical system qualifies for the credit (Br. in Opp. 3-4). As petitioner acknowledges (*id.* at 1), however, the trial of this case occurred before the Fourth Circuit had issued its decision in *A.C. Monk,* which clearly articulated the "adaptability" test for the first time. The Fourth Circuit's opinion, moreover, while rendered after trial of this case, was issued almost a year before the Tax Court wrote its opinion herein. Compare 686 F.2d at 1058 with Pet. App. 25a. The Tax Court thus had ample opportunity to consider, and did in fact consider, the Fourth Circuit's conflicting analysis. Indeed, the Tax Court observed that "the Fourth Circuit has rejected our allocation approach" (Pet. App. 103a n.29) and declined to follow the Fourth Circuit's decision (*ibid.*). Since both courts below explicitly considered the Commissioner's "adaptability" argument, there are no prudential concerns that counsel against granting certiorari here.

Respondent also asserts that this case is an inappropriate vehicle for resolving the circuit conflict "[i]n view of [the Commissioner's] failure to appeal in *Scott Paper*" (Br. in Opp. 4). As we pointed out in our petition (at 5 n.3), the Tax Court's opinion in *Scott Paper Co.* v. *Commissioner,* 74 T.C. 137, was rendered in 1980, but a final decision was not entered at that time pending further trial proceedings that consumed several years. When we drafted our petition, we understood that the Tax Court had still not entered a final decision in *Scott Paper.* See Pet. 5 n.3. Respondent points out (Br. in Opp. 4) that our understanding in this latter respect was erroneous; a final decision in *Scott Paper* was in fact entered on June 26, 1985 (Br. in Opp. App. B1-B6). Because of an administrative error, the entry of this decision was not reported to the Chief Counsel's Office of the Internal Revenue Service. We regret any inconvenience caused by this mistake.

Contrary to respondent's suggestion (Br. in Opp. 4), however, the fact that the Tax Court's decision in *Scott Paper* has become final, and cannot now be appealed, has no bearing on whether the Court should grant certiorari here. During the five-year period in which the *Scott Paper* opinion was on the books but not yet final, the Fourth Circuit went on record as rejecting its rationale in *A.C. Monk,* and the Tax Court expressly adhered to its *Scott Paper* rationale in the instant case. By the time *Scott Paper* became appealable, the government had already taken an appeal in this case questioning the correctness of the Tax Court's view on this issue. That appeal has now resulted in a direct conflict in the circuits, and that conflict is ripe for resolution by this Court.

For the foregoing reasons and those stated in our petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

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